FILE COPY

Office - Supreme Court U. S.
FILED
NOV 14 41
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

October Term, 1941.

No. 29.

AMERICAN SURETY COMPANY OF NEW YORK, *Petitioner*,

v.

THE BETHLEHEM NATIONAL BANK OF BETHLEHEM, PENNSYLVANIA, and L. M. REED, Receiver, The Bethlehem National Bank of Bethlehem, Pennsylvania, *Respondents*.

BRIEF OF RESPONDENTS IN REPLY TO BRIEF OF UNITED STATES FIDELITY & GUARANTY COMPANY, AS AMICUS CURIAE.

GEORGE P. BARSE,
(Counsel for Comptroller of the Currency),
Attorney for Respondents.

H. P. McFADDEN,
Bethlehem, Pennsylvania,
Of Counsel.

LEE ROY STOVER,
HARRIET BUCKINGHAM,
F. RICHARD BURKE,
(Assistant Counsel for Comptroller of the Currency),
Of Counsel.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

Page

A—Reply to the Fidelity Company's Point (3), pages 9-13, that "No Equity Exists on the Part of the Other Creditors of the Bank That Would Prevent the Full Application of the Doctrine of Subrogation" 2

B—Reply to Certain Other Points in the Fidelity Company's Brief 10

CITATIONS.

Fouts v. Maryland Casualty Company, 30 F. (2d) 357.. 11
In re Thompson, 300 Fed. 215 ..... 8, 9
Jenkins, Receiver, v. National Surety Company, 277 U. S. 258 11
Maryland Casualty Company v. Cox, 104 F. (2d) 354.. 6
Maryland Casualty Co. v. Fouts, 11 F. (2d) 71..... 12
Maryland Casualty Co. v. Fouts, 27 F. (2d) 423..... 12
Merrill v. National Bank, 173 U. S. 131..... 5, 8
New Bedford Institution for Savings v. Hathaway, (1883) 134 Mass. 69 9
United States v. National Surety Company, 254 U. S. 73 11
Ward v. First National Bank of Caruthersville, et al., 76 F. (2d) 256 5

IN THE

Supreme Court of the United States

October Term, 1941.

No. 29.

AMERICAN SURETY COMPANY OF NEW YORK, *Petitioner*,

v.

THE BETHLEHEM NATIONAL BANK OF BETHLEHEM, PENNSYLVANIA, and L. M. REED, Receiver, The Bethlehem National Bank of Bethlehem, Pennsylvania, *Respondents*.

BRIEF OF RESPONDENTS IN REPLY TO BRIEF OF UNITED STATES FIDELITY & GUARANTY COMPANY, AS AMICUS CURIAE.

By leave of Court first had and obtained, Respondents submit their reply to the brief of United States Fidelity and Guaranty Company filed in the above entitled cause as *amicus curiae*.

For convenience of designation, the company will be referred to as the "Fidelity Company".

The Fidelity Company's brief is designed to support the position of American Surety Company of New York, Petitioner, and hence Respondents' reply will be governed accordingly.

A.

Reply to the Fidelity Company's Point (3), pages 9-13, that "No Equity Exists on the Part of the Other Creditors of the Bank that Would Prevent the Full Application of the Doctrine of Subrogation."

The opinions of both courts below expressly indicated that their respective decisions were based upon the assumption that Petitioner's cause of action was founded upon the doctrine of subrogation. Apparently in recognition of this, the position of the Fidelity Company is summarized by the following extracts from its brief on page 9:

> "By operation of the doctrine of subrogation, the rights and remedies which a creditor has against the debtor to allow him to recover the debt vest in a surety paying such debt. This is done to thereafter enable the surety to make recovery from the debtor whose primary responsibility it is that such debt be paid."
>
> * * * *
>
> "The doctrine, of course, is equitable in its nature and because of that fact, will not be applied where an inequitable result would be obtained. It is used to further a fairness of treatment among all parties concerned and any court, in applying it, must look to see that no innocent person's rights are prejudiced thereby. If, in this case, the other depositors of the bank could show that the application of this doctrine resulted in their being treated unfairly, then, of necessity, any court would refuse to fully apply it. However, such is not the case."

The second portion of the above quoted extracts (with the exception of the last sentence thereof) summarizes, likewise, the position of Respondents with reference to the inherent equities necessary to be considered in applying the doctrine of subrogation. Respondents submit that the equities of the "other depositors of the bank" will not be served by Petitioner's application of the doctrine of subrogation in the instant case, for the following reasons:

(1) The deposit balance of $135,000 owing to the State of Pennsylvania by the bank at the date of suspension and closing, was paid off in the sum of approximately $67,000 derived from dividends from the Receiver on March 27, 1934, plus liquidation of the pledged collateral on or about April 23, 1934. (R. 4) Consequently by April 23, 1934, the debt of the bank to the State had been paid, to that extent and *pro tanto* discharged, leaving a balance due to the State as of April 23, 1934, of approximately $68,000.

Petitioner paid this balance to the State, under the requirements of its bond as surety, in three installments, the last of which was made on April 28, 1934. (R. 4.)

(2) It would seem necessarily to follow, therefore, so far as substance is concerned, that inasmuch as the bank's debt to the State had been *pro tanto* discharged by the application of the assets of the bank in the approximate sum of $67,000, Petitioner could not equitably acquire, either by subrogation or assignment, that portion of the deposit which had already been discharged by the bank, and that Petitioner, as surety, could not acquire any interest in the debt greater than the remaining unpaid portion of $68,000. Petitioner concedes in its bill of complaint that the payments thus made on behalf of the bank in approximately the sum of $67,000, plus the payment by Petitioner, under its bond, of approximately $68,000—

> "fully satisfied and discharged the claim of said Commonwealth of Pennsylvania on account of the balance standing to its credit on deposit in said The Bethlehem National Bank of Bethlehem, Pennsylvania, on March 15, 1933 and amounting to the sum of One Hundred Thirty-five Thousand Dollars (135,000.00) as aforesaid." (R. 4)

(3) It is settled doctrine that claims against a national bank in receivership can only be for the amount owing by the bank to the claimant at suspension and that dividends are to be paid upon the basis of the claim thus established.

However, such claim is subject to subsequent apportionment.

The payment by petitioner of the sum of approximately $68,000.00 as required by the depositary bond, resulted, by operation of law, in the apportionment to and acquisition by, Petitioner, of a claim against the bank for $68,000.000.

It seems perfectly clear that it would be inequitable, and would constitute an injustice to the other depositors of the bank to allow Petitioner a claim on the sum of $135,000, inasmuch as the bank had already discharged $67,000 of that claim. The allowance of a claim of $135,000 would constitute unjust enrichment of Petitioner, at the expense of the other depositors.

(4) The real relation of Petitioner's claim to the bank may be further exemplified by the following contrasts and suppositions:

Assume, by way of contrast, that shortly before suspension and closing, the cash and liquid assets of Bethlehem National Bank had been depleted by heavy cash withdrawals and that its remaining assets were substantially "frozen" so that it was unable, upon demand of the State, to pay the entire $135,000 deposit balance; assume further that prior to suspension, the bank paid to the State approximately $67,000 of its deposit balance, and that petitioner, under the requirements of its existing depositary bond, paid the State the remaining balance due of approximately $68,000, and that shortly after these payments had been made, the bank had suspended operations and closed, without the surety having been reimbursed by the bank. Petitioner's claim against the bank prior to suspension and closing would, of course, amount to approximately $68,000. It is obvious that the closing of the bank and the appointment of a receiver would not result in any enhancement or appreciation of the claim of the surety, and that the surety could only establish a claim against the bank in receivership in said sum of approximately $68,000.

It seems clear, therefore, that the basic principles are not changed by the fact that the *pro tanto* discharge of the deposit liability by the bank by the application of $67,000.00 of its assets, and the payment of $68,000.00 by Petitioner,—was made after suspension of the bank.

(5) The question of whether the surety shall have, on the one hand, subrogation to the entire amount of the creditor's claim, or, on the other hand, as to whether the surety shall have only partial subrogation, must be measured, in this respect, by the amount paid by the surety under the requirements of its depositary bond. If the surety pays the entire amount of the creditor's claim, the surety is entitled to subrogation to that extent. If the surety pays only part of the creditor's claim, the surety is entitled only to subrogation to a corresponding portion of the creditor's claim.

The respective equities of the surety, and of the general depositors, were considered and balanced, and the balance decided in favor of the general depositors, in the case of *Ward* v. *First National Bank of Caruthersville, et al.*, 76 F. (2d) 256. In that case the amount of the deposit at suspension was approximately $26,000, and the surety, under its bond, expended approximately $4,800 of its own money toward payment of the deposit, the balance of the deposit being paid from the proceeds of collateral belonging to the bank. The surety sought subrogation to the entire amount of the $26,000 deposit. The Circuit Court of Appeals for the Eighth Circuit held that the surety was not entitled to assert a claim for the full amount of the deposit, inasmuch as he had paid only part of the deposit, and accordingly the surety was allowed a claim of approximately $4,800. The surety sought to apply, by analogy, the doctrines in *Merrill* v. *National Bank*, 173 U. S. 131. The court's decision was based, not only upon the conclusion that the *Merrill* case did not apply, even by analogy, but further that the equities preponderated in favor of the general depositors. The fol-

lowing extracts from the opinion of the court are pertinent, particularly in relation to the equities of the case (pp. 257, 258):

> "The only claim the plaintiff had against the bank was for the sum of $4,827.20. This is the total sum plaintiff now seeks. Yet, because plaintiff handed over to the county the proceeds of the collateral which he held by reason of his being a surety, he now seeks to receive dividends on the collateral turned over until the dividends equal the sum of $4,827.20. Such a course of action would inevitably result in paying to the plaintiff a greater percentage on his claim of $4,827.20 than other creditors would receive on their claims. This is stripping the debtor bank of its property, which is a trust fund for its creditors. We think it is not allowable."

* * * * * * * * *

> "(2) Plaintiff became a creditor of the bank by subrogation to the rights of the county when he had paid to the county out of his own funds, in partial liquidation of the bank's debt, the amount he was obligated to pay as a surety on the bond. The amount was $4,827.20. To that extent plaintiff became an unsecured creditor of the bank by subrogation. Any payment that plaintiff made to the county above that sum he paid from funds (county warrants) belonging to the bank and not from funds of his own. The county warrants so used were being held for the benefit of the county as a secured creditor of the bank. Jenkins v. National Surety Co., 277 U. S. 258, 267, 48 S. Ct. 445, 72 L. Ed. 874."

> "(3) Subrogation is purely an equitable right. It will not be enforced where it would be inequitable to do so, or where it would work injustice to others having equal equities."

Attention is also invited to the case of *Maryland Casualty Company* v. *Cox*, 104 F. (2d) 354, which, in essence, involved the same issues presented in the instant case, so far as concerned the amount of the claim which the surety was entitled to assert against the receivership bank for dividend purposes. The surety had only paid part of the

deposit and the court held that it was entitled to subrogation only for the amount which it paid. (See comments of court below (R. 31).)

(6) On page 10, the Fidelity Company suggests that by giving a depositary bond the bank was enabled to retain assets of $125,000 "which it otherwise would have been forced to pledge with the Commonwealth" and consequently that "recovery under that surety bond should be considered precisely the same as recovery from other collateral pledged by the bank".

The equities of the other creditors of the bank, and the extent to which the surety may be entitled to establish a claim against the bank for the purpose of sharing in the general assets constituting a trust *res* for all of the creditors,—cannot, either logically or equitably, be determined by the comparison of situations involving basically dissimilar factors. The bank had the right to employ either of the two methods. If the bank had pledged collateral for the entire amount required, no questions as to the right of the surety could have arisen. On the other hand, the fact that the bank gave a depositary bond, and was thereby enabled to retain a corresponding amount of assets, establishes no causal relation or factor affecting the subrogation rights of the surety. Those rights are determined by, and are dependent upon, the liabilities assumed and the funds expended by the surety under the requirements of its bond, and the surety's rights are not in any way affected by the fact that the bank retained assets which otherwise it would have pledged. The assets belonged to the bank, and not to the surety. The bank paid the surety for approximately five years for assuming the risk under the bond that the bank might fail and that the surety might be called upon to perform its obligation. As pointed out in Respondents' brief (p. 18) the court below took the position, which seems amply supported by the authorities, that the surety was in effect and substance, an insurer.

If, as the Fidelity Company suggests on page 10 of its brief, the surety bond is to be considered as stand-

ing in lieu of an equal amount of collateral, and recovery under the surety bond "should be considered precisely the same as recovery from other collateral pledged by the bank," it would necessarily follow under the doctrines of *Merrill* v. *National Bank of Jacksonville* (1899), 173 U. S. 131, that upon the payment of the State's deposit from the two sources of pledged collateral and dividend payments, the deposit of the State must be considered discharged, and the general assets on hand at the time of the closing of the bank cannot be subjected to further dividends upon the claim.

(7) On pages 12 and 13 of its brief, the Fidelity Company suggests that if the position of respondents were to be upheld, "it would make for the most varying and fortuitous results in the payment of any such surety, as the amount recoverable by a surety would then depend upon the whims of the other parties to the transaction rather than upon such surety's inherent right of reimbursement." Even if sound, the assumed consequences of "varying" results in the repayment of the surety, would not seem to be a material factor. However the exact opposite is true. The surety knows, at the time the bank fails, exactly what its obligation is under its bond. Its duty is to pay the penalty of its bond immediately, inasmuch as the suspension of the bank is tantamount to failure of the bank to meet its obligation on the deposit. The surety can and should immediately pay the amount required of it and therefore the surety has within its own power the determination of, not only the amount it will pay, but also the corresponding amount of the claim against the bank accruing to the surety from such payment.

On page 13 of its brief the Fidelity Company cites *In re Thompson*, 300 Fed. 215, not only in support of its contention that "varying and fortuitous results in the repayment" of the surety would be avoided by adopting petitioner's contentions, but the Fidelity Company also cites said case for the proposition that a surety is entitled to be subrogated to "the creditor's full claim." It may be noted that

in the *Thompson* case the surety paid the entire amount of the creditor's claim, and, therefore, it may be assumed, for discussion, that the paying surety was entitled to subrogation to the full amount of the creditor's claim thus paid. It may be noted further, however, that the case dealt with relations existing between co-sureties, and that there is considerable conflict as to whether under the circumstances in the *Thompson* case, the paying surety was entitled to full subrogation inasmuch as, in substance, the surety could be credited, so far as the co-surety was concerned, with paying only half of the creditor's claim, for the reason that the paying surety was itself obligated to pay one-half of the claim. The Federal Citator does not indicate that the *Thompson* case has been cited or relied upon in subsequent cases. A strongly persuasive view to the contrary, holding that the paying surety is not entitled to prove a claim against the insolvent co-surety's estate for more than half of the primary creditor's claim is indicated in *New Bedford Institution for Savings* v. *Hathaway*, (1883) 134 Mass. 69, 75. In the *New Bedford* case (where the facts and circumstances were closely analogous to the situation in the *Thompson* case) the Massachusetts court said:

> "* * * Because the creditor might have proved and received a dividend upon the whole debt, this affords no reason why the paying surety should. To the creditor the co-surety had promised he would pay the whole debt, but as between the sureties each was a debtor only to the amount of his proportion. To allow a co-surety to exaggerate this claim would do injustice to other creditors of the insolvent surety. It would be using the fiction of the law that the debt is still unpaid,—which is adopted in equity to protect the paying surety by keeping the debt alive in order that securities may be realized for his benefit,—so that unfair advantage would thereby be taken of other creditors of the insolvent. * * *"

B.

Reply to Certain Other Points in the Fidelity Company's Brief.

(1) On page 6 of its brief the Fidelity Company contends that the original depositary indebtedness in the instant case has not been affected or changed, and that:

> "It stands as it did as of the date of insolvency, and there is no portion of it that has been subtracted from the whole to stand alone. The bank's obligation is unaltered, a new ultimate beneficiary of its performance being the only change."

The Fidelity Company further states on page 7 of its brief:

> "When an attempt is made to alter the amount of the original claim after it has been proven, as was the case here, then to the extent of the alteration it will fail to get its ratable share of the dividends. It cannot be contended that the original claim has been satisfied in part and has survived in part, and at the same time, contend that the original claim is continuing to be ratably treated."

The fact is, however, as previously herein pointed out, that the original deposit of $135,000 was *pro tanto* paid off and discharged to the extent of approximately $67,000 by dividends from the receiver and by application of the proceeds of liquidation of collateral belonging to the bank. It would do violence to the equities to ignore that *pro tanto* discharge of the debt, and to confer the benefit of that discharge upon petitioner.

No general formula such as the statement on page 4 of the Fidelity Company's brief to the effect that the amount of any claim against an insolvent national bank is fixed, for dividend purposes, as of the date of the closing of the bank,—can be permitted to override actualities, or to defeat equities. Any such general rules must be qualified by the situation resulting when a surety voluntarily assumes the obligations of its depositary bond. It is presumed to con-

tract with reference to the law, and to abide by the incidents and consequences legally resulting from its contract. It is presumed to know that:

(a) If it pays only part of the primary debt, it is only entitled, in equity, to acquire the portion of that debt corresponding to the amount it paid.

(b) If it pays only part of the claim of the primary debt, its right to assert its claim for dividend purposes will, by reason of the legal incidents relating to suretyship, be deferred until the primary creditor has been paid in full, at which time the surety can start to receive dividends upon a claim measured by the amount it has expended in part payment of the debt. See *Jenkins, Receiver* v. *National Surety Company*, 277 U. S. 258, 263, and *United States* v. *National Surety Company*, 254 U. S. 73, 76.

(c) If its dividends have been deferred by reason of the circumstances indicated in sub-paragraphs (a) and (b) above, and if thereafter, in due course, the general creditors of the bank have been paid in full, leaving the surety's claim partially unpaid by reason of the beginning of its dividends having been deferred,—it then follows, under equitable doctrines, that the surety will be permitted to continue to receive dividends upon its claim from the surplus assets on hand after the general creditors have thus been paid, the result being that the surety will ultimately be paid the full amount of its claim, notwithstanding the deferment of the beginning of its dividends—assuming, of course, that the surplus assets thus remaining are sufficient to pay the residue of the surety's claim. The surety assumes that risk.

(2) On page 14 the Fidelity Company cites and relies upon *Fouts* v. *Maryland Casualty Company*, 30 F. (2d) 357. That case is not authority for the contentions of petitioner that it is entitled to a claim for the entire amount of the deposit. The Fouts decision reported in 30 F. (2d) 357,

is a continuation of, and is circumscribed by, the issues and limitations involved in the preceding cases of *Maryland Casualty Co.* v. *Fouts,* 11 F. (2d) 71, and *Maryland Casualty Co.* v. *Fouts,* 27 F. (2d) 423. The case in 11 F. (2d) was filed by the Casualty Company to establish a claim against a national bank receivership for the sum of $50,000 paid by it in partial satisfaction of a deposit liability of approximately $89,000. The surety was not claiming subrogation to, or allowance of, a claim of $89,000. The allowance of the claim of $50,000 sought in 11 F. (2d) was denied, for the time being, because, under settled doctrines, the primary debt of $89,000 had not been paid and the court would not permit the surety to compete with the primary creditor by way of dividends while the primary creditor was still unpaid. The case in 27 F. (2d) again sought allowance of a claim of $50,000, and the court allowed the claim upon the supposition that the primary creditor had been paid. The third case, in 30 F. (2d), was an appeal from the case in 27 F. (2d). The Circuit Court of Appeals for the Fourth Circuit reversed the decision of the District Court in 27 F. (2d) on the ground, *inter alia,* that as a matter of fact the primary creditor was still unpaid.

In view of the fact that the surety sought a claim for only the amount it paid, rather than the full amount of the depositor's claim, it is obvious that the last paragraph of the *Fouts* case found on page 359 of 30 F. (2d), and partially quoted on page 14 of the Fidelity Company's brief, to

the effect that the surety was entitled to allowance of the claim for the full amount of the primary debt, could be, at most, only *dictum*. However, an examination of that paragraph apparently does not support the construction drawn from it by the Fidelity Company.

Respectfully submitted,

GEORGE P. BARSE,

(Counsel for Comptroller of the Currency),

Attorney for Respondents.

H. P. MCFADDEN,
Bethlehem, Pennsylvania,

Of Counsel.

LEE ROY STOVER,
HARRIET BUCKINGHAM,
F. RICHARD BURKE,

(Assistant Counsel for
Comptroller of the Currency),

Of Counsel.